

## Lessons from Gorbachev

### How to Avoid the Stifling Problems of Over-Centralised Bureaucracy

- In *Memoirs*, Mikhail Gorbachev captured his view of the history of the Soviet Union.
  - The problems included being centralised, bureaucratic, over-planned, cross-subsidised and non-transparent.
  - The emphasis on absolute adherence to the plan stifled all ideas, creativity and innovation.
  - There was a lack of genuine economic incentives. The problem was the system, not any particular leader.
  - There was significant resistance and the transparency of Glasnost helped win the necessary public support.
  - The continuing troubles result from a lack of true freedom, opportunity and accountability.
- Inside companies, many problems of the Soviet Union Persist. Most companies need to give more freedom to manage along with better incentives with opportunity and accountability.

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EVALuation is a series of periodic reports from Stern Stewart Europe Limited, drawing on the depth of our experience and internal research, to cover issues of valuation, organisational design, decision making, remuneration, and corporate governance. Our focus is to assist managers in understanding how their actions affect the value of their organisations. We believe that all stakeholders benefit from the creation of value through both innovation and efficiency.

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“In September, we held the inaugural European EVA<sup>®</sup> Institute senior management conference. The EVA<sup>®</sup> Institute is a forum for our clients to participate in EVA<sup>®</sup> related presentations and discussions, to stay up to date on our latest developments and to share EVA<sup>®</sup> experiences with each other to optimize the benefits they realize from EVA<sup>®</sup>. Our invited dinner speaker for 10 September was Mikhail Gorbachev, but Mr. Gorbachev had to cancel at the last minute due to his wife, Raisa, being ill. Subsequently, Raisa has unfortunately passed away and we offer our sincerest condolences to Mr. Gorbachev and his family.

This issue of EVALuation is meant to capture our view of some of the relevant issues we had intended Mr. Gorbachev to cover in his speech. It is based on his book, *Memoirs*. I am confident you will find the writings of Mr. Gorbachev to have great relevance to business management.”

*Gregory V. Milano, Managing Director, Stern Stewart Europe Limited*

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## Executive Summary

Many in the Western world view the history of the Soviet Union with a bit of amazement. “How could the Soviets have expected their bureaucratic planned economy to have worked?” The world is moving toward enhanced market forces through improved financial markets, the free flow of the internet, reduced trade barriers and vast globalisation. This makes it increasingly difficult for those with a centralised protectionist approach to survive.

**Many companies are centralised, bureaucratic, over-planned, cross-subsidised and non-transparent**

The reality is that while market forces are shaping relationships between companies even when they are geographically dispersed, inside companies many of the problems of the Soviet Union persist. Many companies are centralised, bureaucratic, over-planned, cross-subsidised and non-transparent. They lack the basic structure and incentives inside their company that they seek so strongly outside their company. Just as the state was more important than the individual in the Soviet Union, the company is more important than the individual in most companies. This is both demeaning for the staff and ineffective for the company.

**Mr. Gorbachev wrote *Memoirs* in 1995**

We learn a lot about organisations and reform by looking at the Soviet Union. In 1995, Mikhail Gorbachev wrote *Memoirs*, capturing his view of history for us all to read and learn from. Mr. Gorbachev identifies many of the fundamental mistakes embedded in the design of the Soviet Union. Sometimes we learn more from mistakes than we do from successes.

**Lost sight of economic efficiency**

The Soviet Union was an experiment in socialism. It was a highly centralised ‘planned economy’, which produced extreme bureaucracy and elitism. The planning process used cross-subsidies to achieve its objectives and, as often happens, this led to corruption. Everyone lost sight of economic efficiency and innovation since there were no incentives to be successful. All success rested on political power, not performance.

**The problem is the system, not the leader**

It is easy for us to criticise Stalin or others in the chain of Soviet leadership, but the problem is the system, not the leader. Excessively managed economies (and companies) will inevitably suffer from a lack of innovation and creativity. The very act of aligning all activities with a rigid plan to seek efficiency prohibits all entrepreneurial deviation from the plan. We must allow experimentation and tolerate failure as one of the paths to greater success.

**Easy to hide from reality**

A centralised structure also makes it easy to hide from reality. Everyone wants to please their boss so they find ways of making performance appear commendable. It is difficult to see problems when everyone is pointing out success. Problems are cast aside as mere temporary cyclical disturbances and as long as the plan is followed everything will be alright. The Soviet Union had many opportunities to turn the course of events but constantly ignored the signs.

**Resistance and Glasnost**

Once Mr. Gorbachev began his reform path, many resisted. Any time change is initiated; those who benefit from the system that is being changed resist. Success required the support of the masses. The policy of Glasnost allowed freedom of speech and won public support for change in such a way that the bureaucracy could not successfully resist. Transparency is essential to gaining the groundswell of support necessary for significant change.

**Still having problems today**

We all know the countries of the former Soviet Union are still having problems today. It seems Russia has not been able to achieve the right balance of control and freedom. In the pursuit of relaxed centralised control to eliminate the stifling impact this has on thought, innovation, opportunity, accountability and incentives, they may have gone too far. With completely relaxed or incompetent central control we see chaotic disorder, weak authority, no sharing of ideas, vast inequities, ‘Mafia’ control and rampant fear. Neither extreme is good.

**Essential to have freedom and accountability**

Although it is important to provide as much freedom as possible, it is essential to have adequate accountability through rules that establish incentives, protect property rights, discourage fraud and ensure safety. Russia needs this now.

Most companies also need to give their employees more freedom to manage along with better incentives that provide both opportunity and accountability.



## Introduction

**Topical for Business Leadership**

The parallels are amazing. I bought the book *Memoirs* so I could learn a bit as I was preparing to introduce Mikhail Gorbachev at our inaugural European EVA<sup>®</sup> Institute Conference. I hardly finished the first chapter when I realised just how topical the book is for business leaders. In fact, if we substitute the word ‘company’ for ‘country’ throughout, it could be written by the chief executive of a large business going through substantial change. I highly recommend the book to business leaders everywhere.

**It is difficult to initiate dramatic change unless faced with a crisis**

I have captured some of the key points Mr. Gorbachev makes about the problems of extreme centralisation in the Soviet Union, which led him to realise that a change was needed. He knew something was wrong long before he became General Secretary. As he uncovered problems, he was still unsure of the root cause. As in most companies, if Mr. Gorbachev had initiated change sooner, the transition would have been less painful and more successful. But it is difficult to initiate dramatic change unless faced with a crisis.

**Those who benefit from the system that is being changed resist**

Once he had a clear vision of where the country needed to head, he began a trek that induced more change on more people in a shorter period of time than any other event this century. He took specific strategic actions to disarm the critics. And there were many who pushed obstacles in his way. Any time change is initiated; those who benefit from the system that is being changed resist. They don’t say they do so for selfish reasons, but they do. Removing these obstacles is essential to any successful change program.

**He set out to break down the most centrally managed culture in the world**

Mr. Gorbachev had numerous objectives including breaking down bureaucracy, stopping elitism, reducing cross-subsidisation, decentralising authority to the people, reducing the need for centralised planning, and increasing economic incentives. He set out to break down the most centrally managed economy in the world and give people a reason for living.

**Dream not fully realised**

Of course, we all now know that his dream has not been fully realised. This is largely because when the authority of the centre was dismantled, it was not accompanied by local accountability. A vacuum formed, which was filled by Mafia control – not much has changed after all.

**We can take a few lessons from Mr. Gorbachev**

If we review some of Mikhail Gorbachev’s views on what happened in the Soviet Union we can relate these experiences as suggestions to managers. Many managers speak of the need for deregulation when they look outside their companies to governments and the population at large. They say they need this to be able to be creative and innovative and succeed in the new global economy. But inside their company, they instil regulations and rules, which stifle the very creativity and innovation they seek. Few of us do this consciously but most of us do it subconsciously. We can take a few lessons from Mr. Gorbachev.

## Bureaucracy, Elitism and Planning

**Planners can ‘make’ the economy run as efficiently as possible?**

The central theme to socialism, as it was practised by the Soviet Union, is that a group of central planners can ‘make’ the economy run as efficiently as possible and share the benefits with people as equally as possible. It sounds very civilised. As long as people work to fulfil the plan, everyone will be taken care of. There would be no wasted energy on competition, squandered spending on advertising and meaningless product features that do no more than attract attention on a shelf. We could live in harmony with everyone taking care of everyone.

Of course, this requires a group of central planners who, by their role, are no longer equal with everyone else. They acquire an ‘elitist’ mentality. As planners, they are seen (by themselves at least) to be superior to everyone else. They cannot have individuals making decisions for themselves, as this may not be in harmony with the decisions of others. The role of central co-ordination is to use large volumes of centralised information to plan for those who, due to their incomplete view, cannot plan for themselves.



**Impractical to let local people make decisions that might conflict**

Over time, these planners began to believe everyone outside the planning regime (and undoubtedly many in it) could not think for themselves. Despite the far superior information that was held in each locale about conditions, needs and capabilities, it was impractical to let local people make decisions that might conflict. This led to a ridiculous and somewhat expected (from the Western world) outcome. Mr. Gorbachev wrote:

*...in March 1961 I became first secretary of the Komsomol Krai committee. These four years of my life were packed with bureaucratic routine, a situation that was symptomatic for the Komsomol in those days. One mass campaign followed another. My desk was piled high every day with innumerable instructions arriving from the Komsomol Central Committee. Those at the top seemed to be firmly convinced that without their bureaucratic directives no grass would grow and no cow would calve – and that the economy could only function under a regime of “permanent mobilisation”.*

Imagine the frustration people had when the central planners handled them this way. A farmer would be working a farm and could see the needs around him. Yet, he had to follow the rules set forth by the centre. It was humiliating to be treated this way through misguided objectives. Both morale and motivation suffered, along with productivity.

**Volume of paperwork imposed was tremendous**

Not only was the direction from the centre deficient, the volume of paperwork imposed was tremendous. It was hard for farmers and industrialists to find time to do their jobs because the endless reports consumed so much effort. In the realm of over-centralised management, these documents were necessary for the use of the central planners. But the result was a tremendous waste of manpower in the field. Much of the information was not even used. Whenever we request for information, we ask for anything we might need and we get much that we do not need. The bureaucracy builds upon itself to the point of draining essential energy from society. Mr. Gorbachev wrote:

*I had to face a system of decision-making under the demands of a command economy and a centralised state bureaucracy. Practically all issues had to be put before the State Planning Committee (Gosplan) and approved by a dozen ministries and departments, as well as innumerable officials. Then there were the endless trips to the capital, the cajoling and having to endure abusive language and rudeness from officials. All this taxed the nerves.*

**Bureaucracy & centralised control saps creativity**

Corporate bureaucracy is not much different. Business units compile strategic plans, financial forecasts, annual budgets, monthly financial reports, quarterly forecast updates, quality reports, new business reports, marketing plans, capital appropriation requests, and many other important documents. If these are kept short, containing only necessary information, they are practical tools to manage a company. Unfortunately, these often grow to colossal magnitudes. In many management buy-outs of large company subsidiaries, a quick improvement is the discontinuation of excessive documentation. The head office needs to identify what is truly needed for central decisions, and allow the business unit to address the remainder themselves.

The level of bureaucracy in the Soviet Union grew with each regime. Mr. Gorbachev wrote:

*The things one had to do to humour the red-tapists! A country of wheeler-dealers and go-getters, although one would think that common sense ought to prevail in a planned system.*

*Was it really a planned system? The super-centralised attempt to control every single detail of life in an immense state sapped the vital energies of society.*

**Budgets are negotiated as a benchmark for subsequent performance**

The budget-setting process in companies shows many of these characteristics. The budget is not just the plan, but a benchmark against which performance is measured. It becomes a negotiation. The business unit puts forth a ‘conservative’ budget that they are confident they can beat. All downside possibilities are included but upside opportunities are left out. Some managers seek the lowest budget the head office will approve. Thus, the budget preparation process leads managers to focus on being as mediocre as possible.



Central managers do not accept this. They assign their business analysts to assess the plan and see why it is not more aggressive. The subordinates compile budget criticisms, such as ‘this cost is budgeted too high, this volume is budgeted too low, etc.’. Armed, the head office calls a meeting to ‘discuss the budget’, and the negotiation begins. The head office makes accusations and the business unit defends. The business unit concedes a few points in exchange for dropping some others. The points conceded, of course, were allowed for as negotiating room. As in the Soviet example, one would think that common sense ought to prevail. Unfortunately, the budget process is fraught with hidden agendas, mutual deception, extreme mistrust and sometimes deliberate deceit.

**The origin of the budget was as a process of planning**

But why do we have budgets then? The origin of the budget was as a process of planning. At the start of each year, a business needed to estimate its possible business activities so it could make decisions about the procurement and allocation of resources to try to optimise the success of the operation. Then, someone decided the budget was the best benchmark for measuring performance throughout the year. It seemed logical as measurement could avoid being excessively influenced by external events that were beyond management control. We could separate good performance from good luck and bad performance from bad luck.

**Confuse the planning ‘means’ with the ‘end’ of success**

Unfortunately, once managers learned they would be measured this way; the budget process was corrupted into a counterproductive negotiation. These criticisms of planning should not be interpreted as a call for the end of planning. Through a careful consideration of possibilities and hazards, we avoid ignorance when opportunities arise. However, we must not confuse the planning ‘means’ with the ‘end’ of success.

**Planning is harmful when the emphasis is on control rather than creativity**

Planning is harmful when the emphasis is on control rather than creativity. In many organisations, the leader seeks tighter control and therefore requests more thorough planning submissions. Many planning processes begin with a strong statement of intent from the centre, essentially outlining what the plan should include. Statements such as, “we need to tighten cost management” or “we need to invest in our future”, indicate the direction business units are to follow. A substantial benefit of planning is lost since the creativity of the business managers is immediately stifled before the plan is even developed. If a manager strays from the indicated strategy, they are often reprimanded and described as a poor team player. “The company needs cost management and you plan for significant spending. Are you out of line?”

These problems were extreme in the Soviet Union, leading Mr. Gorbachev to write:

*Should you come up with your own idea, be prepared for trouble. You could even land in jail. There was no room for initiative within a system under which all aspects, including minute details, were determined by the plan and the budget. At the same time, the ‘bosses’ were dissatisfied with low returns, and tried to improve the situation by reshuffling the cadres or creating new management structures.*

If the plan does not work out, the head office reshuffles the organisation chart since the problem must be in poor execution. A few managers are made redundant, a few more are sent to Siberia and several are elevated to new positions of greater authority. Then the plan is refreshed to fit the new organisation and life moves on.

The fear of being a casualty leads managers to kow-tow to the executives by following the plan. Those who follow the plan have better careers! This stifles local creativity, a problem in the turbulent environment we are now in. On this, Mr. Gorbachev wrote:

*Other countries made painful readjustments and then rose to the challenge of the times, whereas our system, supposedly built on scientific premises and a planned systematic approach, as well as scientific management methods, spurned innovation and moved against the general tide of progress.*

**‘Budget Relief’**

Even during the year, the negotiation goes on. If a sudden external event occurs, such as a competitor taking irrational pricing decisions, managers will be given ‘budget relief’ as this was beyond their control. Again this seems logical to avoid penalising bad luck. But when



something bad happens, managers first notify the head office to seek ‘budget relief’, rather than concentrating on minimising the impact of the problem. And since these discussions are held behind closed doors, when relief is given, the appearance of favouritism prevails. Those who do well are said to ‘know how to play the game’.

**Many executives enjoy the power**

Often, these problems are known, but companies do little to change them. The problem is that many executives enjoy the power. With the power to approve budgets comes the power to ask for favours. And few would want to give this up. Mr. Gorbachev wrote:

*People who for decades had held high positions were clearly worried that innovations would catapult them from their armchairs. With the leadership cadres in this frame of mind it was difficult to expect success.*

The system perpetuates itself. Those who benefit from the game rarely want to change the game. Mr. Gorbachev wrote:

*Of course, everything had a simple explanation: no one wanted to let go of power. Whoever determined targets and allotted resources was seen as tsar and god, potentate and benefactor.*

**Action is cosmetic and rarely works**

There is some action taken to address these problems, but it is typically cosmetic and rarely works. Mr. Gorbachev wrote:

*Notwithstanding the importance and complexity of all these problems, they never triggered off any discussion, exchange of opinions or controversy. Eventually, more than twenty permanent and ad hoc commissions were set up to examine the specific issues...*

Problems where nobody wants to face the solutions often have a committee assigned to them. This is as true in large-scale business as it was in the Soviet Union.

### **“Unofficial Relations”, The Lender Mentality and Freedom**

The ‘unofficial relations’ in the Soviet Union were undoubtedly more severe than in most companies. But the abuse of privileges in many organisations is at an unhealthy level.

*Economic ties were entangled in a dense network of ‘unofficial relations’ (extortion and gifts, bribery, exaggeration of results, embezzlement). State property began to be used for personal gain on a massive scale. Production discipline was breaking down everywhere. There were mountains of uninstalled equipment, including imported goods.*

**Central control leads managers to seek favour with their bosses**

In some cases, business unit leaders win favours from the head office by treating executives with special perks. This can include special suites in the local hotel, expensive golf outings, fancy shows, lavish dinners, celebration parties and the like. A portion of this is respectful of seniority. Excess is bribery. The next time the unit is called to ‘discuss the budget’, the negotiation is more in their favour. Mission accomplished.

It does not only happen with senior officers. Second tier executives are often found supporting each other to the boss to give the illusion of teamwork. These support efforts, however, are given in exchange for each other much in the way government legislators trade votes to get their pet projects approved. This clouds the whole decision process.

These practices are often referred to as, “One hand washes the other and both hands wash the face”. Centralisation feeds on this abuse. The Soviet experience shows the lack of adaptability in centrally planned environment. Mr. Gorbachev wrote:

*The problem did not lie only in errors or in undervaluing science and technology, but rather in the archaic nature of our economic mechanisms, in the rigid centralisation of administration, in over-reliance on planning and in the lack of genuine economic incentives.*



Without allowing the masses to contribute to developing the plan, new ideas are lost. New developments in science and technology require a favourable environment for experimentation. This includes a willingness to tolerate failure as part of the cost of achieving success. There was not much tolerance for failure in the Soviet Union.

**Lender-mentality stifles entrepreneurship**

The tightness of the plan obliterated any hope of experimentation. There was no reward. There was no benefit for exceeding the plan but a penalty for falling short. This mimics the rewards of a lender. The best a lender can hope for is the receipt of contractual interest payments and return of principal, any further benefit accrues to the shareholder. So lenders are typically risk averse, regardless of the upside potential of an idea. In the Soviet Union, there was no room for experimentation as there was no benefit from success and a risk of being sacked for failure. With everyone faithfully trying to follow the plan, all diversity of ideas was lost. Mr. Gorbachev wrote:

*...development of any kind is possible only if there is internal diversity. The achievement of an 'ideal' as a result of the complete victory of one trend inevitably leads the newly created system to internal crisis and ruin.*

**People need more freedom and accountability**

He was not criticising the Party, but the fact that there only was one party, one ideology and one plan. How can we ever hope for progress when everyone is following the same line of thought? All desired outcomes were predetermined in accordance with the plan. People need more freedom to observe their local situation, assess alternatives and act. But along with this freedom and authority must go accountability. Mr. Gorbachev wrote:

*...people who assume responsibility should be free to act and use their own judgement.*

Executives should not be obsessed with strategy and planning, but eliminating the barriers to creativity. People are amazingly creative, innovative and adaptive if they have the ability to use their skills. Mr. Gorbachev wrote:

*For me and for those who began perestroika, the key point was 'the elimination of everything that interferes with development'.*

Executives should look at their own company and determine the impediments to progress. It could be an over-emphasis on central planning.

## Cross-Subsidisation

A subsidy is a financial benefit provided to an activity that does not justify it on economic grounds. There are numerous reasons why governments and companies provide subsidies, many of which seem justified. Unfortunately, they often cause more problems than they solve. Mr. Gorbachev wrote:

*"If a farm is inefficient and operating at a loss, then it'll get more: whereas if it's a well-run farm, it will... be told 'you have to look after yourself'. Those with a potential for growth are deprived of our support."*

**Subsidies stifle productivity and growth**

One type of subsidy is when governments provide support to the needy. Many agree this is good as those who are fortunate feel better if some wealth is shared with those who are less fortunate. By providing benefits to the needy, however, we reduce the incentive to work. The number of 'needy' grows and the subsidy is abused. This was not a problem in the first half of the 20<sup>th</sup> century as people were ashamed to take advantage of social programs. Now people feel they deserve these benefits and, whether they need it or not, they maximise what they get from the state. This is a drain on productivity and economic growth, which hurts everyone.

A second type of subsidy is based on time, not need. If a government feels that technology is important for the future, it may subsidise research and development (R&D) through tax



incentives. They fear business may not pursue long term benefits due to the initial cost. The tax incentives pay for a portion of the up front cost to make it more desirable to pursue the deferred benefits. Again, many of us agree that this is a desirable activity.

**Private markets appreciate the long term**

But when governments subsidise R&D, we wind up paying for a share of all R&D, not just the marginal investments that would not have happened without the subsidy. This becomes quite expensive. With increased emphasis on R&D by large companies and venture capital funds, the private market has demonstrated a true appreciation for long-term benefits. Thus, many R&D projects that are encouraged by tax incentives, which would not have happened otherwise, are economically undesirable. The subsidy of such initiatives is unsound when the complete economic system is considered. Wealth is destroyed.

**Governments do not like to be dependant**

A third kind of subsidy is undesirable from the start. The discussion of such matters always sparks controversy, as these are subsidies for historical or emotional reasons. Examples abound, such as subsidisation of agriculture, petroleum exploration and the like. Governments do not like to be dependent on other nations for essentials such as food and petrol. So they subsidise domestic production to reduce the external reliance.

This has evolved into a situation where countries often pay farmers to 'not produce' in order to reduce supply, increase prices and provide more income to those who do produce so they continue to produce. To safeguard the system, trade barriers were enacted to protect the high prices. Huge subsidies shift from consumers paying excessive prices to a small group of farmers, many of whom could otherwise be valuably contributing to society.

The problem with subsidies is that the objective of being economically effective is lost.

**High performers are penalised so poor performers can be subsidised**

A similar problem occurs in many companies. Business units with 'problems' are an embarrassment to senior executives and, as a result, they receive a disproportionate amount of support from the head office. Those who have the competence to succeed get less attention even though this is where the opportunity for the greatest value creation lies. It is not wholly irrational that they spend more time trying to fix problems than they do trying to maximise successes. The problem is actually the policies and incentives that encourage this 'lender-like' behaviour, not the inadequacies of the individual managers.

But what does this lead to? As a manager, if I perform poorly, I get more support from the head office and my targets are adjusted to be reasonable 'given the situation'. Like the government subsidies discussed above, this may seem desirable but the behaviour it encourages is atrocious. There really is no need to perform well. In fact, as long as you can blame problems on the outside world, you will be endlessly subsidised with assistance and easier targets without ever having to deliver. In some companies, greater rewards are consistently given to poorer performers because their poor performance was 'out of their control'. But how can the board of directors, or even the senior head office managers, truly separate the effects of poor management from the turbulence of external factors?

**Subsidies obscure true business performance...**

So far, we have presumed that these subsidies happen because managers believe they are right. An even bigger problem is the subsidy that managers do not even know is happening due to poor information. One business may look profitable while another does not, but the reality might be quite different if the true performance were known. These problems result from poor methods of transfer pricing and cost allocation as well as a lack of proper balance sheet tracking. Mistaken decisions are taken and performance suffers. With the clandestine treatment of information in the Soviet Union, this was a big problem. Mr. Gorbachev wrote:

*...agriculture was regarded as a hopeless liability on the national economy, a sort of bottomless pit absorbing immense resources. Statements claiming that agriculture was 'unprofitable' were found to be wrong. All data pointed to the fact that much more was siphoned off from agriculture than invested in it. And, of course, the nation's economic development had been achieved largely at the expense of the countryside.*

Most bookkeepers in the Soviet government knew that the leaders wanted to build the defence arsenal. By allowing the agriculture to look bad in the figures, they helped the leader achieve



their goal. Siphoning cash out of agriculture seemed reasonable since the performance looked so bad. Few, if any, realised this was damaging one of the few desirable sectors. The Soviet Union was an extreme case of concealed information. Mr. Gorbachev wrote:

*I must say that many of the secrets of the budget were so well kept that I found out about some of them only on the eve of stepping down as President. Nonetheless, I knew the greatest 'secret', namely that our budget was full of holes. It was being continuously replenished by the savings bank, in other words money was drawn from the savings of the citizens and by raising the internal debt. Meanwhile, it was officially proclaimed that the revenues always exceeded the expenditure and that all was very well balanced.*

**...and allow pet projects to be justified**

Executives must be careful. If they are eager to see an initiative succeed, decisions on transfer pricing and cost allocation will make the initiative look better to please the boss. It is bad enough when this sort of 'playing with the figures' happens with the knowledge of the boss. But in reality, it often happens that the leader himself is the one who is deceived. Most organisations would benefit from greater transparency and objectivity.

To be fair, this is tough. In government, subsidies often mask inefficiency. For example, many governments provide subsidised housing to the needy. In New Zealand, they realised the subsidies were obscuring the view of the effectiveness of property management. A few years ago they began to provide direct subsidy vouchers to offset the rent of either state or private property. By separating property management from the provision of subsidies, they encouraged property management to be competitive. This was a very difficult decision, as the subsidy used to take the form of inadequate returns, which do not show up since the expected return is not an accounting cost. Nobody could easily determine how much the subsidy cost, which was favoured by politicians. Transparency is beneficial but it can be painful.

**Better to see the true cost of initiatives**

In many companies, the same difficulty prevails. It is tough to see what new initiatives truly cost out of fear that growth might be stifled. But it is better to see the true cost of initiatives so those managing the initiative can do so efficiently and those making decisions on the future of the initiative have the information to do so.

In the Soviet Union, subsidies were more extreme than any company faces and the behaviour that resulted was also extreme. Mr. Gorbachev wrote:

*The destructive practice of selling equipment, building materials and fuel at high prices, whereas grain and other agricultural commodities were cheap, had to generate some sort of compensatory mechanism, lest the entire agricultural sector went bankrupt. State credits represented one such compensatory mechanism. Farms were granted such loans on an annual basis but no one ever intended to pay them back in full.*

*The argument went: "Since you maintain low procurement prices which keep us from leading a normal life and work, you will always have to give us loans and subsequently write off the debts. There is no other way, you have to feed the country, whatever happens."*

*...under such conditions, there was no need to try to be more efficient and tackle real cost considerations, such as whether a new machine was needed or not. If you can snatch something, just go for it. Payment will be made out of the loans, which are never repaid.*

**To the extent there are subsidies, inefficiency prevails**

This may not happen in companies to this extreme, but to the extent there are subsidies, inefficiency prevails. It is best to increase transparency and openly discuss the cost of initiatives rather than to hide from the information.

## The System, not The Leader

It is often the first act of a new leader to declare the past deficient. This can be a hidden innuendo where instituting new policies implies the past policies were faulty. A more aggressive tact can be where the acts of the past are verbally criticised as the justification for



the new path. In business, this is often accompanied by a large accounting write-off, as if we suddenly find numerous assets that are worthless, businesses that need to be restructured and staff the need to be made redundant. Blaming the past leader allows the new leader some time before the results of the new policies are expected.

In the Soviet Union, Khrushchev began his leadership by heavily criticising Stalin. Mr. Gorbachev wrote:

*The criticism of Stalin... revealed a lack of basic legitimacy. To perceive the tragic events in Soviet history as the result of Stalin's 'evil' nature is a fundamental mistake. If that were the only reason, it would have been sufficient to replace a bad leader with a good one...*

**The problem was the system, not the leader**

Gorbachev viewed the assignment of blame to Stalin as missing the point. The problem was the system not the leader. Of course, as Stalin grabbed far greater power than Lenin ever had or wanted, we could blame him for the system. The excessively centralised system stifles progress and deflates results. Mr. Gorbachev writes of his making the same mistake later:

*At first I was inclined to attribute the failure to achieve the expected results, despite tremendous investment, to the inefficiency and incompetence of the cadres, flaws in the management system or gaps in legislation. ...the situation was taking a turn for the absurd; while the leaders proclaimed achievements, the real state of affairs was worsening. The centre expected positive reports from the field and rapid spectacular results. Well, whenever there is demand, there will be supply. At the beginning of each year, the oblast parties would make unrealistic commitments, which were promptly forgotten. Manipulators were the heroes of the day. Those who worked diligently were looked upon with pity.*

**Dysfunctional systems lead to poor behaviour...**

The system encouraged unfavourable behaviour. Leaders were able to make nonsensical claims of success while the economic situation digressed. Those who could creatively spin a story that made the state of affairs 'look' better were recognised as heroes. Is it totally unexpected that many manipulated the situation for their benefit? It allowed the top leader to cherish achievement. Would he not appreciate those that gave him this fortuity?

So the problem is not that the leaders at various levels are wicked but that the system encourages them to bend reality to their favour. Unfortunately, many who lived in such an environment have limited ability to revert to a success-based mindset. Mr. Gorbachev wrote:

*I felt we would not succeed in implementing reforms in the economy if we did not bring about fundamental restructuring of management structures and decentralisation of management functions. Everyone enthusiastically agreed: without these no reforms would last. It is interesting that even some inveterate bureaucrats spoke in this spirit – apparently they thought that this would not affect them, or perhaps they did not believe that it would really happen.*

**...and only by changing the system can individual potential be realised**

Many who would ultimately suffer in the restructuring supported Gorbachev on these ideas. They must have been ignorant of the eventuality. The key to the success of Gorbachev's changes was to decentralise freedom, planning and decision making while reinforcing this with accountability and incentives. Most did not appreciate the magnitude of this. The individual was going to take precedence over the state. Mr. Gorbachev wrote:

*I said that it was man, his intellectual and political character, his mastery and capacity for creativity, his patriotism and internationalism that will be at the centre of existence and will in the final account determine the success of social transformations.*

Mr. Gorbachev believed people had to rank ahead of the state. If everyone did what was best for him or her, they would be contributing well to society. Do the employees in your company rank ahead of the company?



## No Incentives

Mr. Gorbachev realised that the problem was more than just the lack of decentralised authority, but also a lack of decentralised accountability. He believed people needed to participate in the successes and failures of their actions for them to be motivated to deliver worthy accomplishments to themselves and society. He wrote:

*“The problem [was]... in the lack of genuine economic incentives.”*

Without incentives, why should people work hard? Why should they bother being innovative? Why should they make the effort to be efficient? Given the choice of doing what has always been done or pursuing a new path, when the outcome is the same personally, people continue to do what has been done.

If someone produces an output of 100 and is given 40 for their effort, the yield is 40 percent of the productivity, with the rest accruing to the balance of society. If the output declines to 60 but there is still 40 paid for the effort, the yield rises to 67 percent of the productivity. Economists refer to this as a perverse incentive since the worker receives a ‘percentage’ of output that ‘varies inversely’ with output. And it gets very perverse if the output drops to 20 since the worker would now get 200 percent of output! Of course, planners hope to offset some that have yields above 100 percent with others who yield less. Unfortunately, too many people can do the math and output declines.

**Resetting incentive targets encourages mediocrity**

The company analogy is the resetting of bonus targets annually. In a traditional bonus plan, the higher your profit is this year, the higher your target is next year. Oddly, the better you do, the smaller is the percentage of future profits you can expect. You’d better not do too well! Again, this is a perverse incentive.

There are other such perverse incentives as well. Mr. Gorbachev wrote:

*The main trouble with the old system was that prices, as a rule, were set according to cost. As a result, we did not reward enterprises for economy in their use of resources; we actually punished them, thus encouraging dependence and reliance on state subsidies.*

The reliance on ‘cost-plus’ pricing is a common problem. Over the years, many regulated companies had their prices set based on a fixed profit margin above cost so the conservation of cost actually reduced profits. Much of this is being eliminated now, but the media still criticises regulated companies who economise on cost and therefore show a decent profit.

**Transfer prices are often based on cost, not market forces**

Many of us expect this from government regulation, but it is calamitous that companies often commit this error as well. Internal transfer prices are often based on standard cost or a fixed margin above cost. It appears scientific when business analysts study market prices, as they rightly seek market-based transfer prices, but once the effort is done a target profit margin is derived and from then on the transfer prices are often based on cost, not market forces.

Incentives can also be muted by the fear of people getting rich. Mr. Gorbachev wrote:

*We must create an atmosphere in which it will be possible to act on one’s own initiative. ...even today a businessman here is considered to be self-seeking money grabber.*

**Allowing unlimited rewards for those who deliver superlative performance accelerates economic growth**

In Europe, this fear of greed is much stronger than in the US. People fear that others will ‘take advantage’ of the system and earn unjustified sums of money. They may be exploiting others in the process and unfairly benefiting. Of course, there are cases where this happens and we need basic rules of trade to minimise the occurrence, but it is better to accept a few unjust rewards and promote entrepreneurial spirit than it is to over-regulate activities and squash the desire to innovate and create.

Often the concern about excessive pay comes from the view that we have a ‘fixed size of the pie’. That is, many view the economy as static, where the total income of the population is



fixed and, therefore, if someone earns large sums others must be suffering. But business innovation can accelerate economic growth, raising the incomes of many. Thus, we would like executives and investors to make as much money as possible as this will yield the best outcome for the employees and the rest of society. Greed is not a sinister economic force since it is mostly funnelled toward creativity and growth.

Unfortunately, too many companies do not recognise the value of their human capital adequately and do not allow their middle and lower level staff to participate in the gains the company achieves. This reduces the potential success of the organisation, as these employees do not have an economic incentive for success. This also exacerbates the concern over executive pay.

## Hiding from Reality

**It's difficult to initiate change without a crisis**

Frequently there is an opportunity to rectify a problem before it builds into a crisis but it is difficult to initiate significant change when there is no crisis. Many take the view, 'don't fix what is not broken'. Mr. Gorbachev wrote:

*These were the times when it would have been possible to halt many of the harmful processes in the life of the country and to begin reforming society. Alas, time was running out.*

There would have been less pain in changing the Soviet Union if the changes had begun before the economy dropped into turmoil. But in a centralised regime nobody wants to be the one to indicate the need for change. It becomes easy to convince yourself that this is just a short-term cyclical downturn and we will pull out of it soon.

To boost morale of the masses and feel successful at the top, leaders often find ways of portraying a situation as positive even when disaster looms. Mr. Gorbachev wrote:

*Instead of seeking ways to catch up with other countries and prevent the country and the system from sinking deeper into a state of crisis, the leadership was primarily concerned with devising new artificial ideological concepts which would sanctify the existing realities and present them as historical achievements.*

**Bureaucracy benefits the top so change is very uncommon**

There was little pressure for change from below, but this was to be expected in such a centralised economy. It is very difficult to renew an organisation if everyone fears punishment. The more centralised is the organisation, the more important it is for change to come from the top. Unfortunately, bureaucracy benefits the top so change is very uncommon.

**People need to believe in the vision for change to be effective**

Although change must be initiated from the top, the masses must accept and buy into the change. They must have a vision of what the situation will be after the change so they can judge their own likely outcome. Unfortunately, many organisations have such a constant stream of 'renewal' programs that people become sceptical before an initiative even starts. People joke of the 'management fad of the month'. Management needs to avoid this by only having occasional change and renewal programs but putting strong emphasis behind each one.

Mr. Gorbachev recognised the need for widespread support and wrote:

*Perestroika – the process of change in our country – started from above. It could not have been otherwise in a totalitarian state. But past experience showed that if the spark of reform was not caught by the masses, it was doomed. We had to awaken society from its lethargy and indifference as quickly as possible and involve the people in the process of change.*

The bureaucratic managers who aim to protect their positions magnify the difficult situation. They verbally agree with the change but their actual support is absent. Mr. Gorbachev wrote:

*Many party committees were engaging in very little reform and were trying to sit things out.*



**The key to success is the removal of obstacles**

They had to agree publicly or fear the wrath of the dictator. But as long as they looked supportive but actually resisted, everything was okay. Through misleading communication and a lack of transparency, the masses were ill informed and they grew suspicious. Every change program meets resistance and the key to success is often the removal of obstacles.

**Resistance**

Those who benefit from the status quo work to protect it. They have learned how to ‘play the game’ so they resist any changes that might reduce their opportunities. Those who benefit from pleasing those who benefit from the status quo also protect it. This cascades down into an intense web of resistance. Mr. Gorbachev wrote:

*1965...the September plenum on economic incentives to increase industrial productivity were essentially progressive and aimed at reforming the existing system of economic management. Yet the decisions taken at these meetings were never implemented. An ambiguous situation developed: while the press heatedly discussed all kinds of projects and published articles by economists and publicists, the resurrected ministries were ‘quietly doing their job’, tightening the screws of bureaucratic centralism.*

Engineers refer to such a situation as generating ‘heat and light’ but lacking ‘motion’. Everyone speaks of change and their support for it, but nothing is happening. This is a very difficult situation for a leader since the enemy of change stays hidden. There needs to be a method for encouraging actions and not just talk.

**Actions speak louder than words**

Talk is easy. Presently in Europe there is a groundswell of support for shareholder value. Many describe it as an ideology that is essential for competitive success in the new global economy. Nearly every chief executive states the goal of creating shareholder value in his or her annual report. Yet the reality is that few companies truly embrace the ideology by frequently reporting results, developing plans, making decisions and paying managers in terms of value creation. They continue to focus on accounting measures. They speak of commitment but their actions do not back it up. Investors find ways to discern those who ‘talk the talk’ from those who ‘walk the walk’. Most look to executive remuneration as a guide to what is truly important to management and, sadly, this rarely supports shareholder value.

Just as the investors have to separate talk from action, so must executives when they look at their company. Are change programs truly supported by middle management?

If the change program begins achieving success, often the lack of substantive support turns to outright resistance. This was certainly the case in the Soviet Union and Mr. Gorbachev wrote:

*We discussed the reasons why perestroika was stuck. The feeling was that it had run up against the gigantic state and party apparatus... [and] ...events had convinced me of the need for a tougher approach to the cadres, for the question was no longer one of understanding or ability, but rather direct sabotage.*

And the vehicles for retaining the existing situation through sabotage were amazing. Mr. Gorbachev wrote:

*Agitprop [Department of Agitation and Propaganda] watched over everyone. Censorship played an enormous role in protecting the regime.*

**Censorship reinforces resistance**

Yes, you read that right it is the Department of Agitation and Propaganda! Agitprop worked hard to identify successful changes and then disarm the proponents through censorship and other tactics. Any new ideas that appear to take hold are squashed, making change nearly impossible. Gorbachev kept searching for a means of rallying public support around the change. He realised that without a crisis – some impending doom that must be avoided – it was unlikely his reforms would take hold. People would stop at nothing to keep the regime going, as Mr. Gorbachev wrote:



**A crisis gives  
change a chance**

*It is obvious that the success of failure of reform, especially in the early stages, was wholly dependent on the attitude of the CPSU [communist party] itself, which in essence had to give up voluntarily its own dictatorship. This was an extremely complex political operation, one that was painful for millions of communists and especially difficult, one may say 'lethal', for the Party nomenklatura. 'Abdication of the throne' threatened the gradual loss of the privileges that the nomenklatura had enjoyed.*

*It was clear that the party and state bureaucracy would not welcome these changes. Since at that time the bureaucrats still controlled the main levers of power, there were only two ways of assuring the success of reform; creating significant pressure on them from the majority of society, which was strongly in favour of radical change., and cutting off the most conservative elements of the nomenklatura, inducing all those who were capable of fresh thinking to participate in the transformation. Without political manoeuvring the mighty bureaucracy that had formed under the totalitarian system would never relinquish power.*

This is true of all change. It is very difficult to accept change without fear.. An excellent example is IBM. The company was one of the most successful in the world for decades until the late eighties. But the causes of these problems began much earlier with a general resistance to anything that threatened the established business. The epitome of this was the obstruction of the portable computer business. It is one of the most famous blunders in business history. Although many inside the company, and some outside, knew the problem was building, the mainframe business continued to produce cashflow so there was no crisis. It was not until the financial performance crashed that the crisis was sufficient to instigate the major changes the company went through.

In an unfortunate turn of events, Mr. Gorbachev was given a crisis and he wrote:

*The accident at the Chernobyl nuclear power station was graphic evidence, not only of how obsolete our technology was, but also of the failure of the old system. At the same time, and such is the irony of history, it affected our reforms by knocking the country off its tracks.*

The fear the population faced suddenly allowed the acceptance of reform. People could see that the government could not guarantee economic success – or even basic safety. This incident gave Mr. Gorbachev’s programs a chance they had not had until that point.

But what should a leader do if he sees the need for change but people are content and they face no crisis? I had the good fortune of having lunch with Peter Drucker earlier this year and I asked him this very question using the IBM example above. He acknowledged the need for a crisis and said many companies find if there is none available, they create one.

### **Glasnost**

**People think the  
problem is  
localised**

Often a regime is maintained beyond its successes through tight control and absolute secrecy. As long as people do not know the magnitude of the problems, there is no crisis. There may be a problem in my area, but as long as the rhetoric keeps indicating progress, people feel the problem is localised. In the Soviet Union, Agitprop and other mechanisms were used to maintain this feeling of progress.

Even when people know there are problems, they are afraid to criticise the regime. All change is stifled. In the extreme information deprivation of the Soviet Union, Mr. Gorbachev identified this as a major problem and he wrote:

*It was obvious that the policy of perestroika was seen by many as just another campaign, which would soon run out of steam. We had to eliminate doubts of this kind and convince people of the need for the new course, and so the theme of glasnost – ‘transparency’ – came.*



**A culture of transparency is essential**

He accelerated the process through enhanced transparency and by allowing criticisms of the regime. People were finally able to speak their minds after decades of oppression. People were unhappy and they wanted change. Sometimes the criticisms were hard for the leaders to handle – even sometimes unfair – but Gorbachev knew it was necessary in order to rally public support for a new direction.

Unfortunately, in many companies there is no transparency. People are criticised for speaking their mind and their great ideas are lost. The secrecy imparts a lack of trust where people do not know who or what to believe. Does your company have adequate transparency? If someone has a good idea, do you hear it?

**Reform**

Often, isolated wins are occurring but there is no overall success. Mr. Gorbachev wrote:

*It seemed that we had finally overcome inertia and got economic reform moving. Alas, that was all we had achieved! We had adopted an essentially piecemeal strategy that tackled isolated problems without providing comprehensive solutions. This applied first of all to the campaign to introduce a system of state quality certification. Even then a number of academics and experts expressed the view that we could hope at best for a short-term improvement ... the only reliable quality controller being the customer.*

*People began to blame state certification for disrupted production plans. After only two or three years state certification had vanished... one more clear signal that the solution lay not in administrative or organisational measures, but rather in the restructuring of the entire mechanism.*

**Beware of one-dimensional measures!**

There is a big problem in setting goals based on a one-dimensional measure of success. It is like squeezing a balloon on one end while the air just shifts to the other end. Everyone would agree that more quality is better than less quality with all else equal. But when we set out to improve quality and we consider this an end in itself, everything else does not stay equal. There are typically increases in cost and delays in deliveries. With a one-dimensional focus on quality there is no consideration of whether the increased cost and time are worth it. The only true test of quality is the consumer. Is the consumer willing to pay more and wait longer for a product of higher quality? In some cases yes and in others no.

**It is essential to focus on the right overall goals**

Similarly, a strategy to improve customer satisfaction has led to its measurement. Unfortunately, though better than a quality measure, unusual behaviours are encouraged. Consider Kodak. If their managers wanted to improve customer satisfaction, they could affix a £50 note to the back of each roll of film. Customers would be delighted but within days the company would be insolvent. This may be ridiculous but it illustrates the problems with considering customer satisfaction a goal in itself rather than a contributor to a larger goal.

The Soviet quality program was just another centralised bureaucratic program to try to improve. The problem was not the specific program but the stifling nature of its rigidity. Mr. Gorbachev wrote:

*'Are we going to stifle the people's initiative as in the past, or shall we let them live and work? Don't be afraid that someone might get rich by his own hard work'!*

The message for managers everywhere is simple. Get out of their way, let them be successful and let them participate in the success. Allow the reform program to feed on itself by linking everyone to its success. Mr. Gorbachev wrote:

*The sad state of Russia today is directly due to the fact that at some point the evolutionary approach was abandoned, to be replaced by Sturm und Drang methods, which tore apart our society, destroying people's lives.*



**Allow people to see the future**

Make sure there is a design for the new environment not just a destruction of the old one. Allow people to see their future through this blueprint and above all follow through and deliver the promised end. Do not resort to the turmoil, upheaval and stress of *Sturm und Drang*. Mr. Gorbachev wrote:

*The Party has built up its credibility through the policy of perestroika: not by threat and terror, but rather by going openly to the people and thus stirring up criticism of itself. Now we must win credibility in a new situation – when practical affairs are being tackled we won't win any respect by shutting people up. ... We must let the people feel that we are responding to their criticisms and are ready to act with calm confidence.*

*Indeed, on my trips around the country I increasingly sensed that the administrative and Party structures were applying the brakes. They saw the changes as threats and did everything they could to prevent them. This was their mistake: they should have changed their style and got down to business, working more closely with the people. Instead, they continued to reign, sitting out their time in their offices and storing up ill-will. I had said openly to the entire country (and even louder in closed sessions): 'Those who do not want to change, to get into step with progress, will be left behind. The elections have shown "for who the bells toll."*

To elicit support, it must be very clear that reform success will be achieved and those who do not support the change will not participate in the future.

## Russia Today

**Problems remain in Russia**

We all know the countries of the former Soviet Union still have problems. On 19 October 1999, the Financial Times reported on a new report by the McKinsey Global Institute:

*...the basic rules of a market economy do not yet fully apply in Russia. Russia has created a unique universe of perverse economic incentives. If these were removed, the country could unlock economic growth of 8 per cent a year. In 1991 Russia's labour productivity was 30 percent of US levels; by 1997 it had dropped to 19 per cent. Financial success is more often determined by how skilfully a manager can attract federal or regional subsidies, or negotiate a discount on his electricity or tax bill, than by selling goods efficiently. ...corrupt concession capitalism has elbowed aside clean competitive capitalism.*

*In nine out of 10 sectors covered by the report, poor economic performance is related to market distortions that impede fair competition. These distortions include: different tax rates for different enterprises; preferential access to land and government procurement; different energy prices; variable degrees of red tape; differential law enforcement; differential access to government controlled export infrastructure – all of which invariably favour the less productive companies.*

*Social concerns should be addressed by direct welfare payments rather than indirect industrial subsidies. Failing companies should be allowed to go bankrupt. Yevgeny Primakov, former prime minister, lamented, "The difference between the market and the state is disappearing. As a result, officials sometimes consider public service as a continuation of the market and often interpret democracy as a free market of corrupt services."*

**Balance control and freedom**

It seems Russia has not been able to achieve the right balance of control and freedom. In the pursuit of relaxed centralised control to eliminate the stifling impact this has on thought, innovation, opportunity, accountability and incentives, they may have gone too far. With completely relaxed or incompetent central control we see chaotic disorder, weak authority, no sharing of ideas, vast inequities, 'Mafia' control and rampant fear. Neither extreme is good.

Michael Reynolds of Princeton University wrote an article on Russia, published in the Wall Street Journal Europe, on 24 September 1999, which contained the following:



*It is the inability of the state to provide fundamental order that has fostered the astounding boom in organised crime. Its growth has been so spectacular that, according to former US Central Intelligence Agency Director James Woolsey, it is no longer possible to separate the state from the mafia. Significantly, the one thing the Russian State does seem to do well is to facilitate capital flight. Estimates of the amount of money to have left Russia over the past seven years range from \$200 billion to \$500 billion. Then there's human flight. Russians continue to leave their country, with nearly 400,000 emigrating in the first six months of this year alone.*

Although it is important to provide as much freedom as possible, it is essential to have adequate accountability through rules that establish incentives, protect property rights, discourage fraud and ensure safety. Russia needs this now.

**Decentralised  
authority must be  
accompanied by  
local incentives  
and accountability**

The Russian situation is not unlike the experiences of many companies. Since the sixties, many companies have gone through a repeated cycle of decentralising authority to get closer to customers until things run amok. They then tighten centralised control to eliminate inefficiencies. After a while, the centralised management is too far from the customer and they decide to decentralise and the company runs amok again. In many companies this cycle has turned several times. They think they cannot find the right balance but the reality is that the decentralised model is better but only if accountability is decentralised along with the authority.

Companies can learn much from the experiences of the Soviet Union and Mikhail Gorbachev's account of the events in his book *Memoirs* is an excellent lesson in cultural, social and economic transformation.

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